

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
BERNSTEIN-ON-ESSEX ST., INC. :
for Revision of a Determination or for Refund :
of Sales and Use Taxes under Articles 28 and 29 :
of the Tax Law for the Period December 1, 1984 :
through December 31, 1987. :

In the Matter of the Petition :
of :
SOLOMON BERNSTEIN, :
OFFICER OF BERNSTEIN-ON-ESSEX ST., INC. :
for Revision of a Determination or for Refund :
of Sales and Use Taxes under Articles 28 and 29 :
of the Tax Law for the Period December 1, 1984 :
through December 31, 1987. :

DETERMINATION
DTA NOS. 807165,
807166 AND
807167

In the Matter of the Petition :
of :
RUTH BERNSTEIN, :
OFFICER OF BERNSTEIN-ON-ESSEX ST., INC. :
for Revision of a Determination or for Refund :
of Sales and Use Taxes under Articles 28 and 29 :
of the Tax Law for the Period December 1, 1984 :
through December 31, 1987. :

Petitioners, Bernstein-on-Essex St., Inc. and Solomon Bernstein and Ruth Bernstein, as officers of Bernstein-on-Essex St., Inc., c/o Manheim, Kosson & Novick, 90 Millburn Avenue, Millburn, New Jersey 07041, filed petitions for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period December 1, 1984 through December 31, 1987.

A consolidated hearing was held before Brian L. Friedman, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on October 30, 1990 at 9:15 A.M. Petitioners submitted their brief on March 14, 1991. The Division of Taxation submitted its brief on April 8, 1991. Petitioners submitted their reply brief on May 15, 1991. Petitioners appeared by Lawrence R. Cole & Associates (Lawrence R. Cole, C.P.A.). The Division of Taxation appeared by William F. Collins, Esq. (Mark F. Volk, Esq., of counsel).

ISSUES

I. Whether, based upon the books and records provided to the auditor, the audit method employed by the Division of Taxation was reasonably calculated to reflect tax due and, if so, whether the results obtained therefrom have been shown by petitioners to be erroneous.

II. Whether omnibus penalty, asserted pursuant to Tax Law § 1145(a)(1)(vi), for omission of an amount which is in excess of 25% of the amount of sales and use taxes required to be shown on the return, should be assessed herein.

FINDINGS OF FACT

On March 25, 1988, the Division of Taxation issued a Notice of Determination and Demand for Payment of Sales and Use Taxes Due to petitioner Bernstein-on-Essex St., Inc. in the amount of \$437,802.38, plus penalty and interest, for a total amount due of \$633,497.76 for the period December 1, 1984 through December 31, 1987. In addition, on the same date, the Division also issued a Notice of Determination and Demand for Payment of Sales and Use Taxes Due to this petitioner assessing omnibus penalty (Tax Law § 1145[a][1][vi]) in the amount of \$37,831.08 for the period June 1, 1985 through December 31, 1987.

On the same date, the Division of Taxation issued two notices of determination and demands for payment of sales and use taxes due (in the identical amounts for the identical periods) to each of petitioners Solomon Bernstein and Ruth Bernstein, as officers of Bernstein-on-Essex St., Inc.

Solomon Bernstein and Ruth Bernstein do not contest the Division's determination that

each was liable, pursuant to Tax Law §§ 1131(1) and 1133(a), for sales and use taxes due from the corporation. Therefore, all references hereinafter made to "petitioner" shall refer solely to Bernstein-on-Essex St., Inc.

Petitioner is a Glatt Kosher restaurant which commenced doing business on the lower east side of New York City approximately 60 years ago. It is an internationally-known restaurant and became a landmark for those people who observe the laws of Kashruth (Jewish dietary laws). In 1968, it began serving Kosher Chinese foods. There was both sit-down service as well as an over-the-counter part for take-out orders. During the audit period, petitioner had a large display freezer containing both Jewish and Chinese foods. Prices were posted for meats by the pound and for sandwiches.

Petitioner employed three or four people to serve take-out customers. The guest check books used by these employees were maintained separate and apart from the guest check books used by those who waited on tables. Both taxable and nontaxable items were sold at the take-out counter. The employees who worked at the take-out counter were instructed to write down, on the guest checks, the items sold, the price of the items and the tax charged, if any. However, in most instances, these employees failed to write the items sold on the guest checks and, if they did so, the writing was often illegible. An examination of the sales invoices revealed that tax was charged on all table sales, but only on about one-half of the counter sales.

This audit commenced in October 1987. An appointment letter was sent to petitioner on October 19, 1987 (the appointment was later changed and another letter was sent on November 10, 1987). This letter stated, in part, as follows:

"All books and records pertaining to your Sales and Use Tax liability for the period under audit are to be available on the appointment date. This would include journals, ledgers, sales invoices, purchase invoices, cash register tapes, federal income tax returns and exemption certificates. Exemption certificates not made available may be disallowed in which case you will be held liable for the tax on the transaction."

The letter stated that the period under audit was December 1984 through August 1987. On February 23, 1988, the Division received notification of a bulk sale (the business was sold to Sidney Horn as of January 6, 1988) and, as a result thereof, the audit period was extended

through December 31, 1987. The auditor orally requested records for the last quarter from petitioner's accountant.

The first meeting with petitioner's representative occurred in December 1987. At that time, petitioner's business was examined by the auditor and his team leader. A second examination was done on April 18, 1988, after the business had been sold to Mr. Horn.

Although the auditor initially requested books and records for the period referred to hereinabove, petitioner's accountant stated that, since the records were voluminous, it would take a great deal of time to assemble them. The auditor then requested sales invoices for the period June 1 through August 31, 1987. The accountant again stated that records for an entire quarter would be too voluminous, but that he could provide such records for a seven-day period. However, only two days of sales invoices (guest checks) were provided (October 22, 1986 and June 22, 1987). For the two days of guest checks provided, gaps (in excess of 40%) existed in the numerical sequence. Based upon the number of invoices missing and the average sale determined from the guest checks provided, a dollar value was assigned to the missing guest checks. Additional daily taxable sales were, therefore, determined to be \$5,763.52 (or a percentage of additional sales of 29.5983%).

Gross sales per returns filed (through November 30, 1987) were \$9,337,734.00. Gross sales for December 1987 were projected to be \$259,382.00 (\$9,337,734.00 divided by 36). Utilizing the guest check error percentage (29.5983%), audited taxable sales were determined to be \$12,197,804.00. This amount included disallowed house account sales of \$97,167.00 which consisted of sales to various organizations and religious groups. Since petitioner could not show to the satisfaction of the auditor that the tax collected was actually related to the sales or was, in fact, remitted, tax (\$8,016.20) was assessed thereon. In some instances, tax was assessed on the house accounts based upon petitioner's failure to present properly completed exemption certificates. Tax due on audited sales was determined to be \$1,006,319.00. Tax reported for the period was \$588,479.00. Additional tax due on sales (determined by applying an error rate of 71.0034% [$\$1,006,319.00$ audited tax due - $\$588,479.00$ tax reported =

\$417,840.00 additional tax due divided by \$588,479.00 tax reported] to the tax reported for each quarter) was determined to be \$417,840.10. Based upon the auditor's determination (see Finding of Fact "2") that petitioner's records (guest checks which failed to set forth the claimed nontaxable items sold) failed to properly substantiate claimed nontaxable sales, all sales were deemed taxable. The auditor did admit, however, that, based upon his examination of the business premises and the guest checks from over-the-counter sales, it seemed apparent that petitioner made nontaxable sales.

In addition to the \$417,840.10 in tax due on sales, tax was assessed on overcollections (\$5,922.47), recurring purchases (\$2,366.78) and fixed assets (\$11,673.03) for a total tax due of \$437,802.38, which was the amount assessed per the notices of determination issued March 25, 1988 (see Finding of Fact "1"). The assessment on overcollections resulted from the auditor's determination, after reviewing the two days' invoices presented, that petitioner had, in some instances, charged sales tax at a rate greater than the 8¼% which was in effect during the audit period. The assessments on recurring purchases and fixed assets resulted from an examination of one month's purchase records. The auditor testified that purchase invoices for just one month were provided despite the request for records for the entire audit period and that some invoices were missing for the one month examined.

After the issuance of the assessments, certain discussions between the auditor and petitioner's accountant took place. An appointment was made for a visit to the place where petitioner's records were stored (William Rosenfeld, petitioner's manager from 1968 until the sale of the business in 1988, testified that, after the sale, the records were stored in cartons at a nearby synagogue). The auditor stated that he viewed the records which were stored in various boxes in a remote area and, when he requested records for specific periods, he was told that, since the records were not stored in any particular order, a great deal of time would be required to locate and assemble the records for such specific periods (the auditor stated that he was told that it would take at least one month to locate and assemble the records for any given seven-day period). As a result, the auditor did not attempt to utilize these records and no adjustments were

made, at that time, to the assessment as issued.

A conciliation conference was held by the Bureau of Conciliation and Mediation Services on December 12, 1988 at which time petitioner's representative stated his disagreement with the audit findings as follows:

- (a) all sales, including food sold in bulk at the deli counter, were deemed to be taxable;
- (b) based upon an examination of two days' guest checks, the auditor determined that 40% of such checks were missing. As a result, petitioner's gross and, therefore, taxable sales were increased by 40%. The figure of 40% was arrived at by disallowing any invoices which were not in numerical order in the guest check book; and
- (c) all credit card sales were disallowed even though tax was reported because, in the two-day test, no guest checks for credit card sales were observed.

As a result of the foregoing, the conferee directed petitioner's representative to supply the auditor with four days' guest checks and petitioner's cash receipts journal as well as any proof of nontaxable deli sales. The requested guest checks were furnished and it was determined that all were reported in the cash receipts journal. Nontaxable deli sales were not substantiated. Accordingly, total tax due was revised as follows:

Tax due on disallowed nontaxable sales	\$181,827.28
Tax due on disallowed house account sales	8,016.20
Tax due on overcollections	5,922.47
Tax due on recurring purchases	2,366.78
Tax due on fixed assets	<u>11,673.03</u>
	\$209,805.76

On July 7, 1989, conciliation orders were issued which recomputed total tax due from petitioner to \$209,805.76, plus full penalty and statutory interest, and omnibus penalty was reduced to \$18,221.88. Corresponding conciliation orders were also issued which made identical recomputations of tax and omnibus penalties due from Solomon Bernstein and Ruth Bernstein, as officers of petitioner.

Tax due on disallowed nontaxable and house account sales ($\$181,827.28 + \$8,016.20 = \$189,843.48$) was recomputed as follows:

(a) the disallowed house account percentage of 37.36%, computed by the auditor based upon his inability to verify that sales tax was paid over on these sales, was unchanged. Total disallowed house account sales were, therefore, determined by both the auditor and the conferee to be \$97,166.64 for the audit period;

(b) gross and taxable sales, including the amount thereof projected for the month of December 1987, remained unchanged. The conferee did not, however, increase gross sales as did the auditor who utilized a guest check error percentage of 29.5983% to increase gross and taxable sales by \$2,763,603.30. As a result, audited taxable sales (including disallowed house account sales) were determined to be \$9,434,200.00. By subtracting reported taxable sales of \$7,133,133.00, additional taxable sales were found to be \$2,301,067.00. The percentage of increase was, therefore, 32.25885% (\$2,301,067.00 divided by \$7,133,133.00). By applying this percentage to taxable sales reported for each quarter, additional tax due was \$189,843.48;

(c) claimed credit card sales which were disallowed by the auditor (see Finding of Fact "7[c]") were allowed by the conferee;

(d) tax due (\$2,366.78) on recurring purchases was unchanged; and

(e) tax due (\$11,673.03) on fixed asset acquisitions was unchanged.

Subsequent to the conciliation conference, petitioner furnished additional documentation to the auditor which resulted in an additional adjustment, i.e., tax due on fixed asset acquisitions was reduced from \$11,673.03 to \$1,393.51. Total tax due is, therefore, reduced to \$199,526.24.

The audit report states that the auditor spent approximately seven hours reviewing the file of a prior audit conducted on petitioner's business. Such audit file revealed that petitioner had nontaxable sales.

In his review of the two days' guest checks provided (see Finding of Fact "4"), the auditor saw some guest checks for sales in the \$200.00 to \$500.00 range. The average sale per guest check was determined to be \$23.24.

The auditor determined that of petitioner's total gross sales, 97.29% result from guest

check sales (2.71% were house account sales).

The new owner of Bernstein-on-Essex Street (see Finding of Fact "3"), Sidney Horn, stated in a letter, the content of which was sworn to on March 7, 1989, that, with the exception of the installation of a computerized food tracking and cash register system, the business was being operated in a manner which was identical to its operation prior to the sale. William Rosenfeld, who was an employee of Bernstein-on-Essex Street from 1960 through June 1988 (he was the manager from 1968 through June 1988), testified that the business did not change after its sale in January 1988.

As indicated in Finding of Fact "3", supra, the Division of Taxation received a bulk sale notification on February 23, 1988. The auditor testified that, as a result thereof, he had to issue an assessment on or before March 26, 1988 (the assessments were issued on March 25, 1988).

The auditor testified that an observation test could not be performed because of the change in ownership of the business in January 1988. He stated that this was the case because it could not be ascertained whether or not the business had changed after its sale. He further testified that, in his experience as a sales tax auditor (12 years), observation tests were utilized, in some instances, even after a sale of a business.

SUMMARY OF THE PARTIES' POSITIONS

Petitioner contends as follows:

(a) it is clear from an examination of the business itself, its records, the testimony of both Mr. Rosenfeld and the auditor and from the totality of all of the evidence that petitioner had substantial nontaxable sales during the audit period;

(b) despite knowing that petitioner made substantial nontaxable sales, the auditor failed to utilize an audit method which would properly test such sales. The fact that the business was sold during the audit did not affect the auditor's ability to perform an observation test or to otherwise test for nontaxable sales since it is clear that the nature of the business remained the same after the sale. Moreover, ample time existed, prior to the sale, for the performance of such a test;

(c) since the conciliation conferee accepted petitioner's gross sales as filed, its books and records must, therefore, have been adequate. If so, no test period audit could have been performed since no written consent to perform such test period audit was ever obtained. All books and records were available, but the auditor failed to examine them;

(d) the audit period was extended through December 1987 because of the bulk sale which occurred in January 1988. The taxpayer was never asked to extend the audit period nor did he consent thereto; and

(e) the assessments resulting from a one-month test of purchases (recurring purchases and fixed asset acquisitions) and a two-day test of guest checks (overcollections) should also be cancelled because petitioner never consented to a test period audit.

The Division of Taxation's position may be summarized as follows:

(a) petitioner has failed to meet its burden of proving that the receipts at issue were not subject to tax, as required by Tax Law § 1132(c), since adequate (and auditable) books and records were not made available; and

(b) by virtue of petitioner's failure to maintain proper records, the auditor properly deemed all claimed nontaxable sales to be taxable even though it was apparent that some nontaxable sales were, in fact, made.

CONCLUSIONS OF LAW

A. Tax Law § 1138(a)(1) provides, in part, that if a return required to be filed is incorrect or insufficient, the amount of tax due shall be determined on the basis of such information as may be available. This section further provides that, if necessary, the tax may be estimated on the basis of external indices. The resort to external indices is predicated upon a finding of insufficiency in the taxpayer's recordkeeping such that verification of sales is a virtual impossibility (Matter of Chartair, Inc. v. State Tax Commn., 65 AD2d 44). In such circumstances, the Division of Taxation must select a method of audit reasonably calculated to reflect tax due (Matter of Grecian Square v. State Tax Commn., 119 AD2d 948, 501 NYS2d 219), and the burden is on petitioner to establish by clear and convincing evidence that both the

method used to arrive at the tax assessment and the assessment itself are erroneous (Matter of Sol Wahba, Inc. v. State Tax Commn., 127 AD2d 943, 512 NYS2d 542).

To determine the adequacy of a taxpayer's records, the Division of Taxation must first request and thoroughly examine the taxpayer's books and records for the entire period of the proposed assessment (Matter of Adamides v. Chu, 134 AD2d 776, 521 NYS2d 826, lv denied 71 NY2d 806; Matter of King Crab Restaurant v. State Tax Commn., 134 AD2d 51, 522 NYS2d 978). The purpose of this examination is to determine whether the records are so insufficient as to make it virtually impossible for the Division to verify taxable sales receipts and conduct a complete audit (Matter of Chartair, Inc. v. State Tax Commn., supra; Matter of Ronnie's Suburban Inn, Inc., Tax Appeals Tribunal, May 11, 1989).

B. Tax Law § 1132(c) provides that it shall be presumed that all receipts from retail sales of tangible personal property are subject to tax until the contrary is established and that the burden of proving that any such receipt is not taxable shall be upon the person required to collect the tax or the customer.

20 NYCRR 533.2(a)(1) provides that to satisfy his burden of proof, a vendor must maintain records sufficient to verify all transactions.

20 NYCRR 533.2(f) provides that such records must be in auditable form, i.e., they "must be dated, legible, and maintained and preserved in such manner as to disclose in readily accessible and verifiable detail the basis for and accuracy of the entries reported on the sales and use tax return."

Petitioner's records were not in auditable form. Guest checks from counter sales were often illegible and did not set forth the items sold in sufficient detail as to enable the auditor to determine whether such items were, in fact, nontaxable. Moreover, despite petitioner's protestations that complete books and records for the audit period existed, such records were stored in a remote area within a synagogue, in no particular order. As a result thereof, the auditor properly determined that petitioner's books and records were inadequate to perform a detailed audit and his resort to external indices (test period audit methods) for assessing tax on

overcollections, recurring purchases and fixed asset acquisitions was proper. Petitioner has failed to sustain its burden of proof to show that the Division's assessments relative thereto were erroneous and such assessments (\$5,922.47 on overcollections, \$2,366.78 on recurring purchases and \$1,393.51 on fixed assets) are, therefore, sustained. In addition, petitioner has produced no evidence to refute the Division's assessment of tax in the amount of \$8,016.20 on house account sales.

C. The majority of the assessment at issue (\$181,827.28) relates to the disallowance, by the Division, of petitioner's claimed nontaxable sales. As previously stated in Conclusion of Law "B", supra, the Division's resort to external indices was proper based upon petitioner's failure to produce adequate books and records for audit. However, what must next be carefully considered is the rationality of the audit method employed and the amount of the assessment resulting from the Division's deeming all of petitioner's sales to be taxable.

The revised assessment (see Finding of Fact "8") resulted from taking reported gross sales for periods through November 30, 1987 (\$9,337,734.00) and adding in a projection for the month of December 1987 (\$259,382.00), which was determined by dividing gross sales by 36 months, the total of which was \$9,597,116.00. This amount was then multiplied by 97.29% which represented the percentage of gross sales from guest checks (the remainder were from house account sales) to arrive at a figure of \$9,337,034.00. Reported taxable sales were subtracted and the remainder was deemed additional taxable sales since the conferee (as did the auditor previously) held all sales to be taxable.

Whether or not this was an employment of an external index is highly questionable. While some estimates were utilized, i.e., sales for December 1987 and percentage of guest check sales to total sales, it appears that the Division of Taxation merely chose an audit method by which the provisions of Tax Law § 1132(c) clearly kept the burden of proof with petitioner to prove the existence (and the specific amount) of its nontaxable sales.

The evidence presented at the hearing, i.e., the testimony of the manager, William Rosenfeld, the letter from the new owner of the business, the prior audit in which the auditor

stated that petitioner had been allowed some nontaxable sales and, most importantly, the testimony of the auditor himself in which he admitted that, based upon his examination of the business premises and the guest checks from over-the-counter sales, it seemed apparent that petitioner was making nontaxable sales as well as taxable sales, indicates that it was patently obvious that at least a portion of petitioner's sales were of the nontaxable variety.

Is it then a reasonable audit method to simply deem all sales to be subject to tax when it is clear that that was not the case? I think not.

In his closing argument, the Division's representative referred the Administrative Law Judge to Matter of Reference Library Guild (Tax Appeals Tribunal, August 4, 1988), where, in a case involving the alleged nontaxable sales of books to out-of-state customers, the Tribunal stated:

"The inability of the petitioner to submit direct documentary evidence to prove any out-of-state sales placed the Division in a position on audit of not being able to identify any individual exempt sales. As a result, the Division concluded that to accept gross sales on petitioner's Federal tax return as accurate and to treat all such sales as taxable for purpose of determining petitioner's liability was a reasonable audit methodology. While this audit may not be immune from criticism, we are unable to see what alternatives the Division had in determining petitioner's out-of-state sales. The fact that petitioner's business had ceased operation at the time the audit was commenced and the fact that there were no records of petitioner's sales for any period under audit precluded the utilization of a 'test period' or observation test of petitioner's business to estimate tax liability."

In the present matter, the business was in operation at the time of the commencement of the audit and, while it was sold approximately three months thereafter, the business continued to operate in a substantially identical manner. While petitioner's records (guest checks, purchase invoices, etc.) were apparently not complete for the periods tested by the auditor, substantial records did exist. In addition, unlike Matter of Reference Library Guild (*supra*), the business was in operation at the time of the commencement of the audit (October 1987) and remained in the control of the Bernsteins until January 1988. Although the business was then sold, the evidence is overwhelming that the nature and manner of its operation did not change thereafter.

Tax Law § 1138(a)(1) provides, in part, that:

"[i]f necessary, the tax may be estimated on the basis of external indices, such as stock on hand, purchases, rental paid, number of rooms, location, scale of rents or

charges, comparable rents or charges, type of accommodations and service, number of employees or other factors."

These "indices" or "factors" imply the use of some assembled data to produce a rational result. No indices or factors were utilized in this audit. This determination does not stand for the proposition that certain external indices are more preferable to others. It does, however, hold that the totality of the circumstances must be considered in determining whether a particular audit method is reasonable. When the primary issues concern the existence and the amount of nontaxable sales such as sales of meat by the pound and prepared food in an unheated state (see, 20 NYCRR 527.8), to simply deem all sales taxable, when the evidence is clear that that was not the case, is not reasonable. While there was testimony from petitioner's manager that approximately 50% of the over-the-counter sales were taxable (the auditor also stated that, of the guest checks for over-the-counter sales examined, approximately one-half included tax), there is no indication in the record as to what percentage of total sales were attributable to over-the-counter sales. This fact makes a recalculation impossible. Therefore, in light of the unreasonableness of deeming all sales to be taxable when the evidence clearly indicated otherwise, petitioner has sustained its burden of proving that both the audit method selected and the assessment resulting therefrom were unreasonable and erroneous and this portion of the assessment (\$181,827.28) must, therefore, be cancelled.

D. By virtue of Conclusion of Law "C", supra, the omnibus penalty imposed pursuant to the authority of Tax Law § 1145(a)(1)(vi) must be cancelled since it cannot now be shown that petitioner omitted an amount greater than 25% of the amount of tax required to be shown on the tax return. Notices of determination issued to petitioners assessing omnibus penalty only (Notice Nos. S880325048M, S880325049M and S880325050M) are therefore cancelled.

The remaining notices of determination issued to petitioners are reduced, in accordance with Findings of Fact "8" and "9" and Conclusions of Law "B" and "C" from \$437,802.38 to \$17,698.96 (\$8,016.20 on house account sales, \$5,922.47 on overcollections, \$2,366.78 on recurring purchases and \$1,393.51 on fixed asset acquisitions), plus penalty and interest.

E. The petitions of Bernstein-on-Essex St., Inc. and Solomon Bernstein and Ruth

Bernstein, as officers, are granted to the extent indicated in Conclusion of Law "D"; the notices of determination issued to such petitioners on March 25, 1988 for omnibus penalty only (Notice Nos. S880325048M, S880325049M and S880325050M) are cancelled; the Division of Taxation is hereby directed to modify the remaining notices of determination issued to petitioners on March 25, 1988 in accordance with Conclusion of Law "D"; and, except as so granted, the petitions are in all other respects denied.

DATED: Troy, New York

12/27/91

ADMINISTRATIVE LAW JUDGE